VZCZCXRO5884
RR RUEHLMC
DE RUEHLM #0793/01 1360936
ZNR UUUUU ZZH
R 160936Z MAY 06
FM AMEMBASSY COLOMBO
TO RUEHC/SECSTATE WASHDC 3375
INFO RUCPDOC/USDOC WASHDC
RUEHNE/AMEMBASSY NEW DELHI 9626
RUEHKA/AMEMBASSY DHAKA 9188
RUEHIL/AMEMBASSY ISLAMABAD 6078
RUEHKT/AMEMBASSY KATHMANDU 4113
RUEHKP/AMCONSUL KARACHI 2014
RUEHCG/AMCONSUL CHENNAI 6631
RUEATRS/DEPT OF TREASURY WASHDC
RUEHLMC/MILLENNIUM CHALLENGE CORP

UNCLAS SECTION 01 OF 02 COLOMBO 000793

SIPDIS

STATE SA/INS; MCC FOR D NASSIRY AND E BURKE

SIPDIS, SENSITIVE

E.O 12958: N/A
TAGS: ECON CE
SUBJECT: Central Bank reports 6% GDP Growth Sri Lanka in
¶2005.

¶1. (U) Summary: According to the Central Bank, Sri Lanka's economy grew by 6% in 2005 compared with 5.4% in 2004. Post-tsunami reconstruction, debt moratoria and foreign grants

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and loans helped mitigate the adverse effects of the December 2004 tsunami. Main contributors to growth were telecommunications, exports, construction, financial services and domestic agriculture. Foreign remittances of USD 1.96 billion, mostly from Sri Lankan workers abroad, helped to partially offset a USD 2.5 billion trade deficit. While the budget deficit increased to 8.7% of GDP, there was a notable improvement in government revenue. Inflation and monetary expansion was high, but began to ease towards year end. The Government expects economic growth to accelerate to 6.9% in 2006. The Bank also highlighted the need for additional structural reforms to improve growth prospects. End Summary

GDP growth

¶2. (U) On April 27, the Central Bank released its 2005 annual report and announced that Sri Lanka's economy grew by 6% in 2005 - compared to 5.4% in 2004. Total GDP was USD 23 billion and per-capita income reached USD 1,197. All three major sectors contributed to growth. Services, the largest sector, accounted for 56% of the GDP, followed by industry (27%) and agriculture (agriculture, fisheries and forestry) (19%).

¶3. (U) The agriculture crop sub-sector (excluding fisheries and forestry), which had been a drag on overall growth in the recent past, bounced back strongly, growing by 8.8%, and was a positive contributor to growth in 2005. Tea and rice production reached record levels -- Sri Lanka achieved self sufficiency in rice, helped by good weather and government assistance (through an expensive fertilizer subsidy). Rice production accounts for about 3% of GDP. Other non-plantation agricultural crops also improved and contributed 8.5% of GDP. In the industrial sector, the manufacturing sub-sector (including export industries) increased by 6%. Construction expanded by 8.9% due to an expansion in infrastructure and post-tsunami reconstruction. Services grew by 6.4%. Telecommunications has grown strongly by 27% and government services by 5.1%. While fisheries and tourism contracted sharply due to tsunami damage, their small contribution to GDP (less than 2% each), meant relatively

little drag on growth.

External Trade

¶4. (U) On the external front, the trade deficit expanded by 12% to USD 2.5 billion. However, this was partially offset by strong growth in remittances. Worker remittances were USD 1.9 billion and tsunami-related current remittances were USD 50 million. As a result, the current account deficit held at USD 650 million or 2.8% of GDP.

¶5. (U) Exports grew by 10.2% to USD 6.3 billion and imports by 10.8% to USD 8.9 billion in 2005. The petroleum bill increased by 37% to USD 1.65 billion, and accounted for about 19% of the import bill. Sri Lanka's oil import bill has doubled since 2003. Sri Lanka's key garment exports increased by 3.1% and comprised 45.6% of overall exports. Tea, rubber products and food products also recorded higher growth rates. The US was the largest export market, with a share of 31%.

¶6. (U) Foreign grants and loans (including tsunami assistance) and debt moratoria helped to offset the current account deficit and the Balance of Payment recorded a surplus of USD 500 million. Foreign Direct Investment inflow was USD 272 million. Consequently, external reserves improved by 24%, to USD 4.2 billion, sufficient to cover 5.7 months of imports. The debt service ratio was 6.3% (exports, services and remittances). The rupee appreciated slightly in 2005.

Government finances

¶7. (U) Government fiscal performance has been mixed. The government was unable to stick to fiscal targets and the budget deficit increased to 8.7% of GDP from 8.2% of GDP in

¶2005.

¶2004. Government expenditure rose due to tsunami-related expenses and a sharp rise in government expenses on subsidies and salaries (due to new hiring and wage increases). According to the Central Bank, the government has spent about Rs 33 billion (USD 330 million) (1.4% of GDP) on oil and fertilizer subsidies in 2005 (additional to be settled bills still remain). Total defense spending was Rs 82 billion (USD 820 million) (3.5% of GDP). Public investment was 6.3 percent of GDP, including tsunami reconstruction expenditure of 1% of GDP.

¶8. (U) On the positive side, total revenue increased by 22% and amounted to 16.1% of GDP reversing a gradual decline in revenue seen since 1999. Tax revenue increased by 20% to 14.2% of GDP. Total government debt stock has increased by Rs 82 billion (USD 820 million), but as a ratio of GDP it declined to 93.9% of GDP from 105% of GDP in 2004. This was due to the appreciation of the rupee and the higher growth in nominal GDP.

Inflation and monetary policy

¶9. (U) Monetary expansion was high in 2005. Average annual inflation was 12% in 2005, and interest rates remained below inflation. Money supply grew by more than 20%. Private sector credit grew by 21.5%. In response, the government increased key policy rates on four occasions. Together with improved supply conditions, inflation declined from a peak of 16% in February to 8% by December 2005, and showed signs of further weakening in the first quarter of 2006. Monetary expansion also showed signs of slowing by the end of 2005. Interest rates remained below inflation in 2005.

Economic outlook for 2006

¶10. (SBU) According to the medium term macro economic framework included in the report, GDP growth is forecast to

accelerate to 6.9% in 2006. According to the Central Bank, a growth rate of over 8% is required to solve the problems of unemployment (running around 8%) and poverty on a sustainable basis. The Central Bank noted growth will depend on restoring peace, inflationary control and slowing monetary expansion. Inflation is expected to slow to 8% in 2006 (though the Central Bank Director of Economic Research suggested to Econchief that he believes it will run at about 10% most of the year). Monetary expansion is targeted at 15%, a rate that Sri Lanka agreed to target during an IMF visit in late 2005. The bank also warned that high oil prices could cause problems to the Balance of Payments, government fiscal control, exchange rate management, inflation and further weaken the financial position of the related state utilities. In order to mitigate oil price effects, the bank has urged the government to adjust prices, phase out subsidies and restructure energy related public institutions. The Central Bank has also highlighted the need to take on structural reforms to improve public infrastructure, health and education and the efficiency of public institutions. Further, the bank has identified the need to enlighten the general public of the benefits of free and liberal economic policies, structural reforms, competition, the cost of protection and subsidies and the role and limitations of the public sector.
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